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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1942.

Nos. 11-19, 32

IN THE MATTER OF
CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY,
Debtor.

GROUP OF INSTITUTIONAL INVESTORS AND MUTUAL SAVINGS BANK GROUP,
Petitioners,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, ET AL.,
Respondents.

RECONSTRUCTION FINANCE CORPORATION,
Petitioner,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, ET AL.,
Respondents.

BRIEF OF HENRY A. SCANDRETT, WALTER J. CUMMINGS AND GEORGE I. HAIGHT, TRUSTEES OF THE PROPERTY OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, RESPONDENTS.

A. N. WHITLOCK,
Counsel for Henry A. Scandrett, Walter J. Cummings and George I. Haight, Trustees of the property of Chicago, Milwaukee, St. Paul and Pacific Railroad Company, Respondents.

September 23, 1942.

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STATEMENT OF THE CASE.

The Trustees of the property of Chicago, Milwaukee, St. Paul and Pacific Railroad Company were appointed by the Court in reorganization proceedings under Section 77 of the Bankruptcy Act and, under the supervision of the

Court, are administering the Trust Estate and operating the properties of said railroad. They are interested in bringing the trusteeship to a close as promptly as possible by the completion of reorganization under a plan which the property can reasonably be expected to support. When this proceeding was before the Circuit Court of Appeals, the Trustees stated that, in the light of their experience in the operation of the property, they believed that the plan here under consideration, which was proposed by the Interstate Commerce Commission and approved by the District Court, was a workable one and one which the railroad could support. They reassert that position.

The contentions made by the various parties to this proceeding involve, in the main, questions of distribution of securities and comparative treatment as between the various classes of creditors. The Trustees take no part in these controversies as they feel that they do not directly concern them. There are, however, certain questions having to do with the successful operation of the plan and which will necessarily be involved in the carrying out of any plan for this carrier. With these questions the Trustees feel they are concerned. Two such questions are involved, the first having to do with the provision of the plan for an Additions and Betterments Fund, and the second with the provision for the treatment of the Terre Haute Lease.

The statement and the argument of the Trustees will be limited to those questions.

The Circuit Court of Appeals, in dealing with both of those questions, as it did in dealing with the other questions presented, with the exception of the treatment of stockholders, stated that additional findings are necessary upon which to base a final conclusion. (R. 2313, 2314.) (*In re C. M. St. P. & P. R. R. Co.*, 124 Fed. (2nd) 754.) The Trustees believe that there is no necessity for additional findings as to either of the questions mentioned, that the record contains all findings that are necessary, that the

evidence is ample to support the provisions of the plan with reference to both questions, and that such questions of law as were involved in their disposition were correctly decided by the District Court. (R. 1857, 1899.) (*In re C. M. St. P. & P. R. R. Co.*, 36 Fed. Supp. 193.)

For convenience, the provisions involved will be summarized briefly:

Additions and Betterments Fund.

The plan provides (R. 1332) that the available net income for each calendar year, beginning January 1, 1939, shall be determined by deducting from the consolidated income available for fixed charges for such income period all fixed charges and all other charges properly deductible from such income in determining income after fixed charges under accounting rules in force but excluding contingent interest, Additions and Betterments Fund and Sinking Fund requirements and the available net income resulting shall be applied, first to the creation of a fund to provide ~~for or~~ to reimburse the treasury of the reorganized company for the cost of additions and betterments to the mortgaged property. The amount so set aside shall not be less than $2,500,000, cumulative for one year, and may be in such additional amount as the Board of Directors shall determine, provided that the total set aside for this purpose shall not exceed $5,000,000, or 4% of the railway operating revenues, whichever amount is greater, less any amount applied out of the Reserve and Retirement Fund for the income period for capital expenditures other than payments of equipment obligations and payments on account of new equipment, and, provided further, that such additional payment shall be made only out of available net income remaining after the payment of the full contingent interest on the General Mortgage, Series "A", Bonds of the new company and the modified Terre Haute

Bonds, as provided in the Plan. In other words, there is a mandatory Additions and Betterments Fund of $2,500,000 payable out of earnings following fixed charges, and a discretionary Additions and Betterments Fund following the interest on the General Mortgage, Series "A", Bonds and the modified Terre Haute Bonds.

The Terre Haute Lease.

The Terre Haute Line consists of approximately 350 miles of railroad extending from a point south of Chicago Heights, Illinois, to Westport, Indiana. (R. 2163.) The line is leased to the Milwaukee under a 999-year lease from July 1, 1921. Under the terms of the lease the Milwaukee is required to pay the interest and principal upon four issues of Terre Haute Bonds aggregating $21,929,000. (R. 2215.) The bonds consist of four issues, one of $250,000 which matured July 1, 1938, a second of $7,287,000 which matures February 1, 1951, and two others, one of $8,056,000 and the other of $6,336,000, which mature December 1, 1960. All are 5% bonds with the exception of the second issue mentioned which is a 4% bond. The lease also requires the Milwaukee to pay not to exceed $12,000 a year for the expense of maintaining the Terre Haute's corporate existence, to pay all taxes and to maintain and replace equipment. It is provided that at the end of the term the lessor, in order to repossess itself of the leased property, is required to repay the principal sums so paid upon the bonds and also the fair value of additions, betterments, improvements and extensions, the cost of which shall not be represented by any then outstanding bond or other evidence of indebtedness made or issued by the lessor and secured by a lien upon the leased property, or any portion thereof. The Capital Stock of the Terre Haute is 41,730 shares, each share having one vote, of which the Milwaukee owns 97%. The holders of Terre Haute In-

come Bonds, which comprise one of the issues above referred to, are entitled, under the terms of the mortgage, to 63,360 votes upon corporate questions. (R. 2163.) No petition for reorganization under Section 77 has been filed in behalf of the Terre Haute Line.

The Commission, in dealing with the situation (R. 2214, 1302, 1330), concluded that the Terre Haute Bondholders were not such creditors of the Debtor as would be bound by a confirmed plan of reorganization which would divest them of their existing liens upon the Terre Haute properties and the plan provides that a proposal should be made to such bondholders that the existing Terre Haute Mortgages be modified by Supplemental Indentures extending the maturity dates to the same date as the maturity date fixed for the First Mortgage, Series "A", Bonds of the new company, providing for fixed interest on all Terre Haute Bonds at the rate of 2.75% per year and contingent interest, in addition, at the rate of 1.5% per year contingent upon the earnings of the new company to the same extent, in the same manner and with the same limitations as provided in the plan with respect to the payment of interest on General Mortgage, Series "A", Income Bonds of the new company. The proposal also includes the waiver of all equipment vacancies up to the effective date of the plan, January 1, 1939, contains a provision for the replacement of equipment retired after the effective date with equipment purchased under Equipment Trusts and a provision that a new lease may be entered into with the Terre Haute to replace the existing one. The plan provides that if the proposed modifications are accepted by substantially all of the Terre Haute Bondholders, they shall become effective approximately as of the consummation of the plan and that upon confirmation of the plan the said provisions shall be submitted by the Reorganization Committee to all Terre Haute Bondholders and

the result of such submission reported to the Court. The plan then provides:

> "Should the court determine that the foregoing provisions relative to the treatment of the Terre Haute bonds and the Terre Haute lease shall not have been accepted by substantially all of the Terre Haute bondholders, then the existing lease between the Terre Haute and the Debtor, together with the guaranty of the payment of the principal and interest of the Terre Haute income mortgage bonds, shall be rejected, insofar as the plan herein approved is concerned, as of the date of such determination by the court, without prejudice to either the negotiation of a new lease or a consolidation of the properties of the Terre Haute with those of the new company, on terms subject to the approval of this Commission." (R. 1331.)

ARGUMENT.

Inasmuch as the Circuit Court of Appeals bases its reversal upon the alleged failure of the Commission to make sufficient findings and applies that ground in its discussion of all of the controverted issues presented, with the exception of the treatment of the stock, the Trustees assume that the other parties to the proceeding, who will deal with all of the controverted questions, will fully discuss the general question of the necessity for specific findings by the Commission in approving a plan of reorganization in a Section 77 proceeding. Since this brief is limited to a discussion of the two points referred to in the Statement, as to which it is believed there are adequate findings, no attempt will be made to present exhaustively the general question of the necessity for findings. It is appropriate, however, to point out that prior to the enactment of Section 77 the doors of the Bankruptcy Court were not open to railroads. Section 77, in a comprehensive way, provides for railroad reorganization, defines the respective duties of the Commission and the courts and sets forth in detail the procedure to be followed and, in particular, the procedure with reference to the preparation and approval of a plan of reorganization. The procedure which must be followed is strictly statutory and the statute provides, Section 77 (d), 11 U. S. C. A. 205 (d), that, after a plan is filed, the Commission, unless the plan shall be considered by it to be prima facie impracticable, shall, after due notice, hold public hearings at which interested parties may be heard and following which the Commission shall render a report and order in which it shall approve a plan, which may be different from any which has been proposed, that will, in its opinion, meet the

requirements of subsections (b) and (e) of Section 77, and will be compatible with the public interest, or shall render a report and order in which it refuses to approve any plan. The statute then provides:

> "In such report the Commission shall state fully the reasons for its conclusions."

The only references we find in the section to a finding are in subsection (e) where it is provided that submission of a plan to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed, certain alternative findings, one of which is "that at the time of the finding the equity of such class of stockholders has no value." There is a similar provision in the same sub-division with reference to submission to creditors. The Commission complied with these requirements. (R. 1341, 2260.) The District Court approved the Commission's finding (R. 1991) and the Circuit Court of Appeals approved the finding of the Commission and the District Court. (R. 2311, 2335.)

I.

The Commission Complied With the Requirements of the Statute in Providing for an Additions and Betterments Fund.

The provision of the plan for an Additions and Betterments Fund is summarized in the Statement. Certainly, the Commission, in its report, set forth fully the facts making necessary an Additions and Betterments Fund and the reasons for its conclusions as to such a provision. It is a matter of common knowledge, which should not require proof or extended discussion, that additions and betterments are necessary in connection with the operation of a railroad. Very substantial amounts are expended annually and charged to additions and betterments for purposes

which are not income producing, such, for example, as expenditures to promote safety and eliminate fire hazards, amounts expended to comply with orders of the Interstate Commerce Commission and other governmental agencies and expenditures to provide facilities necessary for adequate service and efficient operation, including replacement of structures, installation of heavier rail, renewal of bridges, grade separations and things of that character. It may be said that the bulk of the expenditures classed as additions and betterments are for items of the character mentioned as distinguished from such items as the construction of new lines or the extension of existing lines. Such expenditures must be met either from income or from borrowed money and it would seem bad business practice to restrict a railroad to the use of credit for such necessary purposes and not permit it to meet such requirements out of income, before paying all contingent interest.

The Commission's report contains a very complete discussion of the nature and extent of the requirements of this carrier for additions and betterments and from the report it appears that when this proceeding was before the Commission no one questioned the propriety of an adequate Additions and Betterments Fund. There was some difference of opinion as to the amount. The amount suggested by the Committee representing the Institutional Investors was $2,500,000. (R. 2192.) The Debtor insisted that the amount should be a minimum of $5,000,000. (R. 2203.) The discussion of the Commission as to the respective claims is set forth fully. (R. 2223.) The record shows that in the years 1924 to 1934, $5,000,000 per annum were required for additions and betterments in addition to the amount of cash made available by the charging of road property retired and replaced to operating expense. (R. 362.) The amount expended for additions and betterments during the period of trusteeship appears from Exhibit 6,

introduced at the court hearing. (R. 1527.) From this exhibit it appears that the amount so expended for the period July 1, 1935, to December 31, 1940, which includes several lean years, was $29,863,490. If there were applied against this amount the total of road retirement charges in operating expenses and of salvage from property retired, there would still be a balance of over $17,000,000 for additions and betterments for the 5½ year period which would have to be met either from income or by borrowing. The anticipated requirements for additions and betterments, as shown at the hearing before the Commission, are set forth in Exhibit 121, introduced at Record page 558, from which it appears that the anticipated annual requirements for such purposes are $6,000,000. In its supplemental report the Commission reviews quite fully the question of additions and betterments. (R. 1287-1294.) We call attention to this statement contained in the Commission's report (R. 1289):

> "Generally speaking, the expenditures for additions and betterments have varied in proportion to earnings available for interest. Ordinarily with a rising trend in traffic and revenues the carrier would need more or better facilities, and the increased income should properly provide, in part, for their cost. In years of minimum earnings, it appears that a payment of $2,500,000 to the additions and betterments fund would be sufficient. Placing the discretionary additional payment after the payment of interest on the new general-mortgage series-A bonds would materially enhance the value of those bonds. We are of the opinion that this change in the plan will not operate to deprive the new company of cash for additions and betterments when improvements, extensions, etc., are needed to handle increased business, because in that event the record justifies the conclusion that the earnings will be such as to cover all the interest requirements of the series-A bonds and the contingent interest requirements of the modified Terre Haute bonds."

No one has claimed that less than $2,500,000 per annum is required for this property and no party has ever claimed that there were insufficient findings upon this question. We are at a loss to understand what additional findings could possibly be required. The need was apparent and the extent of the requirement was fully considered and decided in the light of the experience of the carrier over a period of years.

(a) There Is No Valid Legal Objection to the Provision in the Plan for an Additions and Betterments Fund.

The attack that was made upon the Additions and Betterments Fund in the Circuit Court of Appeals was based in the main upon the contention that bondholders have the right under the mortgages securing their bonds to resort to the assets of the mortgagor and the income therefrom for the payment of their debt and that no portion of such income can be diverted for use to meet the cost of additions and betterments but that, on the other hand, such charges are capital charges and cannot be deducted from or charged against income. An effort was made to support this argument by reference to the Accounting Classifications of the Interstate Commerce Commission. The fact is, however, that under the Accounting Classifications of the Commission provision is made, under Income Account 554, for the disposition of net income for investment in physical property and this item is definitely stated to include construction or acquisition of new lines and extensions and additions to and betterments of property the cost of which is chargeable to road and equipment accounts. One group contended that sound accounting would require that withdrawal from income for the purpose of additions and betterments should be credited to junior creditors and stockholders, whereas a senior mortgage group contended,

on the contrary, that the provisions for the Additions and Betterments Fund would unjustly enrich junior groups at the expense of the senior mortgage bondholders. Obviously, both theories could not be sound and we believe it is equally obvious that neither theory is sound since both are bottomed upon the erroneous contention that income may not be appropriated for additions and betterments. It would be just as reasonable to say that income could not be used to properly maintain a railroad property. The universal practice under retirement accounting has been that where a facility is retired and replaced, its cost at the time of retirement, less salvage, is charged to operating expenses, thus making available cash for use in providing additions and betterments, a practice which has universally been conceded not to violate or infringe upon any rights of bondholders.

Section 77 (b) provides that a plan of reorganization—

> "(1) shall include provisions modifying or altering the rights of the creditors generally or of any class of them, secured or unsecured, either through the issuance of new securities of any character, or otherwise * * * (5) * * * and may include any other appropriate provisions not inconsistent with this section."

If the contention of the bondholders to the effect that their liens would be impaired or modified by virtue of the operation of the additions and betterments provision were sound, and we submit it is not, the right of the Commission and the Court to modify the rights of such creditors by this means is clearly contained in the provision of the statute quoted.

That the Commission feels the necessity for an Additions and Betterments Fund in reorganization plans is evidenced by the fact that such provisions are found in practically every plan which the Commission has approved.

By way of example, we call attention to—

Chicago Great Western R. R. Co. Reorganization, 233 I. C. C. 63, 78.

Chicago and North Western Ry. Co. Reorganization, 239 I. C. C. 613, 635.

Erie R. R. Reorganization, 240 I. C. C. 469, 485.

St. L. & S. F. Ry. Reorganization, 242 I. C. C. 523, 553.

Such a provision has likewise met with uniform court approval. In the case of *Denver & Rio Grande Western Railroad Company* the District Court was of the opinion that such a capital fund should come out ahead even of fixed interest charges.

In Re Denver & Rio Grande Western R. R. Co., 38 Fed. Supp. 106 at page 117.

The District Court in our case in discussing the question, said (R. 1888):

"The necessity for an adequate Additions and Betterments Fund in the maintenance and operation of any railroad is obvious. There is ample evidence in the record to support the conclusion that the amount of $2,500,000, provided for this purpose, is necessary in addition to the funds available from equipment depreciation charges and road retirement charges in operating expenses and salvage recovered from property retired. Such additional amount must either be provided out of earnings or the railroad must borrow it. In the light of railroad experience in the past, it would seem preferable that such requirements be met from earnings. Reasonable provision for additions and betterments to be paid out of earnings does not, it is believed, violate any rights of the security holders."

The Circuit Court of Appeals, in disposing of the case (R. 2313), says this about the Additions and Betterments Fund:

"The serious attack made on that portion of the

plan which calls for the mandatory payment of $2,500,000 into the Additions and Betterments Fund, calls for no extended discussion. Counsel contend that the sum is excessive and unfair and does not affect all security holders equally. We think otherwise.

"While there must be more fact findings upon which to reach a final conclusion on this, as well as the other phases of the plan, we believe the Commission is entirely sound in its position that a fund for Additions and Betterments should be created. In fact we find few things in the plan which appeal stronger than this provision.

"Failure to provide against financial and commercial storms and other adversities which affect railroads, like other industries, accounts for much of the condition of the railroads today. The possible avoidance of such recurrence will be aided by this or a similar provision. It would be improper to pass directly upon the reasonableness of the amount, however, until the findings which must be made are before us. However, we may say that there is evidence that would amply warrant an allowance for such an item, and also the amount adopted by the Commission. But findings there must be, based on the evidence, which support both the allowance and the amount of the allowance."

It will be observed that the Court concludes that the sum provided is neither excessive nor unfair and, in the light of this statement, the evidence in the record, the conclusion of the Commission supporting it and the Court's approval of such a fund in general, we are at a loss to understand what useful purpose any additional findings would serve.

In connection with this point, this Court's attention should be called to the fact that the Interstate Commerce Commission, by an order of June 8, 1942, which will become effective on January 1, 1943, and which applies to railroads generally, provides for depreciation accounting for roadway and structures, omitting certain items like rail, ties and track fastenings. After that date, depreciation will be

charged upon such property. The provision in the plan for an Additions and Betterments Fund provides that if the reorganized company shall establish and maintain an operating expense account for roadway and structures, then the Additions and Betterments Fund shall be paid from the Reserve for Depreciation on Roadway and Structures, so credited in respect of the applicable income paid to the extent that the amount so credited to said Depreciation Reserve shall be adequate therefor. (R. 1332, 1334.) While it is impossible at this time to predict with certainty the effect of applying depreciation accounting to this class of property, it is quite probable that the amount of depreciation upon such property may be sufficient to take care of the mandatory requirement for additions and betterments under the plan.

II.

The Findings as to the Terre Haute Lease Were Adequate and Fully Justified the Commission's Treatment.

When the Commission came to deal with the Terre Haute Lease, it found, as set forth in its report, that the line was subject to four outstanding mortgages with reasonably early maturities (R. 2169) and with annual interest charges amounting to $1,023,580; that the aggregate principal amount of the bonds, $21,929,000, was in excess of the cost of reproduction of the Terre Haute property less depreciation, together with the value of lands and rights, found to be $20,680,114 (R. 2164); that the property was leased by the Terre Haute to the Milwaukee under a lease dated in 1921, copy of which is part of the record, Exhibit 63 introduced at Record page 283; that by the terms of that lease the Milwaukee was required to pay the interest upon the outstanding bonds, all taxes and the further sum of not to exceed $12,000 yearly for corporate expenses; that it was also required to maintain the property and to replace

equipment vacancies. The estimated cost to replace such vacancies as of December 31, 1937, was $7,106,149. (R. 2170.) The Milwaukee further agreed in the lease to pay the principal of the outstanding Terre Haute Bonds at maturity but the Terre Haute, in order to repossess itself of the property at the end of the term, was required to repay the amount expended by the Milwaukee in paying the principal of the bonds and also the fair value of all additions, alterations, betterments, improvements and extensions.

The history of the Terre Haute property and its acquisition by the Milwaukee was set forth in the report of the Commission's own investigation previously conducted.

Chicago, Milwaukee & St. Paul Railway Company Investigation, 131 I. C. C. 615.

The Commission found that the earnings of the Terre Haute property for a period of years had been sufficient to more than cover the interest requirements upon the bonds, but in commenting upon the earnings, the Commission said (R. 2213):

> "It may be safely concluded that the earning power of the Terre Haute is sufficient to cover all interest requirements, but this earning power is largely dependent on a continuation of the Milwaukee's coal traffic, together with the commercial coal traffic that accompanies it, and would be greatly diminished if such traffic ceased. The present arrangement is distinctly to the advantage of the Terre Haute."

The Commission concluded, as a matter of law, that the Terre Haute bondholders could not be bound by a plan which would divest them of their existing liens. Nevertheless, as stated by the District Court, the Commission and the Court were—

> "faced with the duty of passing upon the reasonableness and fairness of a plan from the standpoint of all parties in interest and the public and while they may not have jurisdiction to deal directly with the interests

of the Terre Haute Bondholders, they do have not only the right but the duty, in the formulation of such plan, to deal with the property of the debtor, including its rights as lessee, or otherwise." (R. 1878.)

The Commission concluded that a proposal should be made to the Terre Haute Bondholders for certain modifications of their bonds as outlined in the Statement of the Case, and, in case this proposal should be refused, the plan directed the cancellation of the Terre Haute Lease.

The thoroughness of the Commission's analysis of the situation is indicated in the following discussion leading up to the proposal which was to be made to the Terre Haute Bondholders (R. 2214-2216):

"Due to the comparatively low income which the system can fairly be depended upon to earn for the payment of interest and for other corporate purposes in the future, the fixed-interest charges of the system must be reduced to a point that results in a substantial reduction of the principal amount of fixed-interest obligations. Income bonds and securities junior thereto must, to a large extent, replace existing fixed-interest bonds. If the $21,929,000 of Terre Haute bonds may not share in this repiacement process and the plan requires their assumption in full, with their existing liens, it would mean that these $21,929,000 of bonds would constitute approximately 27 percent of the total amount of new fixed-interest bonds, exclusive of equipment obligations, which we find should be authorized in the reorganization. As stated, there are also outstanding general mortgage bonds of the debtor, the principal and accrued interest of which amount to approximately $156,000,000. These bonds are secured by a first lien upon approximately 6,000 miles of railway east of Mobridge, which constitute the heart of the system. The cost of reproduction, less depreciation, plus the value of lands and rights, of this so-called heart of the system was approximately $359,000,000, as stated in the report of our Bureau of Valuation,

compared with $20,680,114 representing similar elements as to the Terre Haute properties stated in the same report. It is apparent that if adequate recognition be given to the highly-secured claim of the Finance Corporation and to the claim of the Northern on its underlying first-mortgage bonds in the allotment of allowable fixed-interest bonds, the allotment of such fixed-interest bonds to the general mortgage bondholders could not be more than double the amount of the existing Terre Haute bonds, whereas the mileage represented by the general mortgage is about 18 times that of the Terre Haute, and on the basis of the elements of value just described for the lines covered by the general mortgage, about 17 times that of the Terre Haute properties. The problem is succinctly stated by counsel for the debtor in discussing the situation as to the Terre Haute securities in the event we should find that the fixed charges should be substantially less than $6,500,000. He said: 'It may be doubted whether the holders of senior liens upon the debtor's own 10,000 miles of property can be expected to consent to an arrangement which contemplates the continuance of the operation of the 10,000 miles, with no substantial return on their invested capital, merely to provide fuel consumption to support the payment of full fixed interest on the Terre Haute bonds, representing 300 miles.'

"Under the circumstances, we shall approve as part of the plan, provisions for dealing with the Terre Haute bonds in a manner which bears a fair and equitable relationship to the treatment accorded the bondholders of the debtor, does not require a consolidation of the properties, and yet accords to the Terre Haute bondholders the same security under the existing mortgage, respectively, as their present bonds hold. However, these provisions, in order to become an effective part of the plan, will have to be accepted by substantially all of the Terre Haute bondholders."

The offer to the Terre Haute Bondholders involved an extension of the maturities of the bonds, the waiver of equipment deficiencies and provided for an interest rate of

2.75% per year fixed and 1.5% per year contingent, making a total interest rate of 4.25% on all bonds, whereas the existing bonds carry a rate of 5% with the exception of one issue of $7,287,000 which is a 4% bond. The Commission again considered the matter at the time it made its supplement report and at that time, in discussing the possible rejection of the proposal by the Terre Haute interests, said:

> "In the event of rejection there would seem to be no alternative but a rejection of the present lease, and the plan so provides. Such rejection is not intended as a threat. It is a necessary step in order that the processes of reorganization of the Milwaukee may not be thwarted. Without rejection of the lease the difficulties of effecting a reorganization, along the lines of the capital structure shown in the approved plan, are evident. The present interest charges on the Terre Haute bonds are approximately $1,023,000 a year. This exceeds the fixed interest requirements in respect of the modified Terre Haute bonds, under the approved plan, by about $420,000. Retaining the present fixed rental payments and at the same time keeping total fixed interest charges to about $4,270,000 a year, as provided in our plan, would thus necessitate reducing the amount of new first mortgage bonds issuable by $10,500,000. Such reduction would mean a substantial sacrifice by the creditors of the debtor who are to receive first-mortgage bonds in part settlement of their claims—a sacrifice in favor of the Terre Haute bondholders which, in our opinion, would be entirely inequitable. There would still remain unsettled the matter of the equipment vacancies on the Terre Haute. Under these circumstances we consider that there is no justification for the approval of a plan based upon the assumption by the new company of the lease, the guaranty of the Terre Haute income bonds, and the other obligations growing out of the lease. If the Terre Haute bondholders do not accept the proposals for modification of bonds, etc., a rejection of the lease clearly would be justified in order that the reorganization may proceed according to the plan." (R. 1303.)

Whether or not the proposal, which the plan provides shall be submitted to the Terre Haute interests, should be accepted by them is a question for their own decision. Certainly, all of the facts bearing upon the question were before the Commission and were considered by it and the Commission's conclusions embodying the terms of the offer to be made are set forth in its report.

In considering the claim of the Terre Haute interests as to the fairness of the plan, it is interesting to compare the position of the Terre Haute Bonds before reorganization with the position claimed for them. For the year beginning approximately at the time of filing the petition in this proceeding the fixed interest charges of this carrier amounted to $14,458,250. (R. 24.) Fixed interest charges proposed in the plan amount to $4,269,654. The interest on the Terre Haute Bonds was approximately 7% of the total fixed interest charges at the date of bankruptcy, whereas, if they were allowed their full interest and all of it were fixed, it would amount to almost 25% of the new fixed charges so that their comparative share of the earnings of the reorganized carrier would be materially improved.

It is submitted that the Commission was not required to provide in the plan that any proposal should be made to the Terre Haute Bondholders. Likewise, although both the Commission and the trial court have found that the offer made was a fair and reasonable offer, which conclusion is not disputed by the Circuit Court of Appeals, it is further submitted that the question of the reasonableness or fairness of the offer is in no way determinative of the validity of the plan as it affects the Terre Haute for the reason that the Terre Haute interests are not required to accept the proposal if they do not like it. So that the matter boils down to the question of whether or not the Commission could in its plan provide for a cancellation of the Terre Haute Lease.

Stated another way, the ultimate issue presented by the Terre Haute Lease is whether or not the Commission has power to reorganize the Milwaukee on any other basis than by leaving the Terre Haute Lease without modification in any particular. The arguments advanced by the Terre Haute interests in both courts involve this ultimate question.

We believe that Congress gave the Commission power to deal with the Terre Haute Lease and to cancel it if that was decided to be the appropriate thing to do. Section 77 (b), 11 U. S. C. A. 205 (b), provides, among other things, that a plan of reorganization—

> "may reject contracts of the debtor which are executory in whole or in part, including unexpired leases; and may include any other appropriate provisions not inconsistent with this section."

The Commission's plan effectively exercises the power so granted.

Many technical considerations have been presented in an effort to achieve the result that all sacrifices in this reorganization should be borne exclusively by system creditors and that the Terre Haute be allowed to escape any sacrifice.

The Terre Haute interests argue that the right to reject is limited to burdensome leases. Not only does the quoted statute impose no such limitation, but the Commission found, upon the evidence before it, that the existing lease was so burdensome that its adoption would jeopardize the successful reorganization of the Milwaukee. (R. 1303.) They further argue that the Terre Haute Lease is a profitable lease, looking only at the earnings as computed, forgetting for the moment such offsetting items as equipment deficiencies, overlooking their relative treatment as compared with their existing position and ignoring the finding of the Commission that their earnings are dependent upon the maintenance and continued operation of the rest of the

Milwaukee System, therefore making it necessary, as found by the Commission, that treatment should be accorded the Terre Haute which would bear a fair and equitable relationship to the treatment accorded the bondholders of the debtor. (R. 2216.) This issue has been found against them and the record supports the finding.

Upon this question it should be pointed out that where, as in this case, so many questions and considerations are involved, the determination of whether or not a lease should be approved or rejected is, in the last analysis, one of business judgment.

Mercantile Trust Company v. *Farmers' Loan & Trust Company*, 81 Fed. 254.

The court, in that case, said:

"1. The issue in the court below presented a question of business policy, and not a question of law. The decision and order of the court were administrative, rather than judicial. That court and its receivers were not liable for the debts nor bound by the obligations of the mortgagor when they took possession of its property. The receivers, under the direction of the court, had the option to assume or to renounce the leases of the branch roads, which they found in the possession of the mortgagor, within a reasonable time after their appointment. *Ames* v. *Railway Co.*, 60 Fed. 966, 970, 971, and cases there cited. In due time, they recommended the renunciation of these leases, and asked permission to execute it; but the master, after a full hearing upon the facts and the law, recommended their assumption. The question before the master and the court was, which course would be of greater advantage to the trust estate? This was a question of business policy, upon which the minds of reasonable men might well differ. None of the parties in interest had the absolute legal right to a determination of this question in either way. The appellant, by bringing its bill in the court below, had imposed upon that court the duty of deciding which course would be of greater benefit to the

trust estate confided to the receivers. It decided that the assumption of the leases would be. One who invokes the aid of a chancellor to operate railroads, and to control and conduct vast business operations, on his behalf, ought not to be permitted to reverse the administrative orders of the court for mere mistakes of business judgment. Administrative orders, which involve mere questions of business policy in the conduct of a receivership, are largely discretionary, and should not be disturbed by an appellate court, in the absence of any abuse of the discretion of the chancellor. Since there was no abuse, but the most careful and deliberate exercise, of its discretion by the court below we think the order appealed from should not be disturbed."

It is submitted that there can be no question under the statute of the right of the Commission in its plan to reject this lease without more. Instead of taking that action, it offered to the Terre Haute Group an alternative which it found to be reasonable and in its report it sets forth fully its reasons for so finding.

The Circuit Court of Appeals, in its opinion, gives no indication that it disagrees with the Commission's conclusions. It is likewise clear that that court has no doubt as to the right of the Commission to provide in the plan for immediate and unqualified rejection of the Terre Haute Lease. The Court in fact criticizes the entire Terre Haute transaction (R. 2311) and says (R. 2314):

"Whether this lease should not be now terminated presents a separate question which can only be determined when findings are made."

The fair inference is that the Court is inclined to the view that the Terre Haute Lease should be cancelled without more. As previously stated, it is difficult to see what additional findings could have been made, in addition to those actually made, which would be useful in deciding the question.

(a) The Provision of the Plan Fixing the Effective Date of Rejection of the Terre Haute Lease Was Authorized by the Statute and Justified by the Facts.

Another technical argument which the Terre Haute interests advanced in both courts below in support of their contention that the Milwaukee must continue the Terre Haute Lease without modification, which they will no doubt reassert here, is that the plan of reorganization is unsound for the reason that the effective date of rejection of the Terre Haute Lease, if it is rejected, shall be the date of determination by the Court that the proposal to be made to the Terre Haute Bondholders shall not have been accepted by substantially all of them.

The basis of their argument is that the Trustees have a reasonable time within which to elect to adopt or reject outstanding leases but if decision is made to reject, either by the Trustees or in the plan itself, then, such rejection must, as they say, relate back to the date of bankruptcy and from that time forward the operation of the property is for the account of the lessor. It is insisted that this rule is immutable and inflexible and that under it if there is a rejection the lessor is entitled as a matter of right to the earnings of the property from the date of bankruptcy.

It is submitted that there is no such rule as contended for by the Terre Haute Group. There is a rule, based upon equitable considerations, that a receiver or a trustee has a reasonable time within which to reach a decision upon the matter of adopting existing contracts or leases. The application of this rule necessarily involves the question of what the receiver or trustee of the lessee shall pay for the use of the property during the period while he is making up his mind as to whether or not to adopt or reject the lease. An examination of the authorities shows that the answers to this question are by no means uniform but vary depending upon the particular circumstances involved,

the true rule being that equity and justice shall be done under the circumstances of each case. In some cases the receiver or trustee is required to pay, during this period, the rental stipulated in the lease. In others, where the earnings are not sufficient to provide the stipulated rental, he has been permitted to discharge his obligation by paying the amount of the net earnings.

In *Westinghouse Electric & Mfg. Co.* v. *Brooklyn Rapid Transit Company*, 6 Fed. (2nd) 547, one of the cases strongly relied upon by the Terre Haute Group, the court, after reciting the circumstances in the particular case, said:

> "This statement seems to us conclusively to show what idle pother may be made by attempting to inject rigid rules into what is essentially an endeavor to be equitable, *i. e.* fair—in a receivership accounting."

It is submitted that the Terre Haute Bondholders place due emphasis upon the so-called doctrine of relation back to the date of bankruptcy. A criticism of that doctrine will be found in *Railroad Leases and Reorganization*, 49 Yale Law Journal, 1409, where the case of *Palmer* v. *Palmer*, 104 Fed. (2nd) 161, another decision relied upon by the Terre Haute Group, is discussed. It is there stated that although the outcome of the Palmer case is justifiable upon the basis of equity practice, the emphasis given to the relation back doctrine seems misplaced. In the same article, in discussing this question, the author says:

> "The present tendency, if it exists, for this equitable principle to solidify into an unyielding rule should not be encouraged."

There are many cases where receivers and trustees of lessees have been required to pay the stipulated rent during the trial period.

Farmers' Loan & Trust Co. v. *Northern Pacific*, 58 Fed. 257.

United States Trust Co. v. *Wabash Western Ry. Co.*, 150 U. S. 287, 308.

Century Building Co. v. *Goetz*, 41 Fed. (2nd) 498.

Sparkes v. *Jensen*, 53 Fed. (2nd) 433.

The cases in which the receiver or trustee has been permitted to discharge his obligation by paying the net earnings for the period of his occupancy are all cases in which the earnings have been less than the stipulated rental and the question involved in each of such cases has been whether or not the receiver or trustee was required to pay the stipulated rental or a lesser sum.

The authorities we believe are unanimous in holding that the trustee in no case will be required to pay during the trial period more than the stipulated rent.

The following authorities support that view:

Sunflower Oil Company v. *Wilson*, 142 U. S. 313, 322.

City and County of Denver v. *Stenger*, 295 Fed. 809.

Oscar Heineman Corp. v. *Levy & Co.*, 6 Fed. (2nd) 970, 973.

Harris Trust & Savings Bank v. *Chicago Railways Company*, 39 Fed. (2nd) 958, 965.

Finletter, "The Law of Bankruptcy Reorganization," 1939 Edition, 228-231.

2 Gerdes on Corporate Reorganization, 1147.

16 Fletcher, Cyclopedia of Corporations, Sec. 7794.

Mr. Finletter states the rule as follows:

"The rights of a party to a contract which has been rejected are, usually, first, to prove a general unsecured claim against the estate for such damages resulting from the breach as are allowed by applicable local law, or specific provisions of the Bankruptcy Act, second, to the extent that he has rendered performance

to the estate during the period of deliberation by the trustee, to claim as a preferred creditor for the fair value of the performance, not to exceed the stipulated contract rate, and, third, to prove as a general creditor for any deficiency between the fair value of the performance rendered by him during the administration by the trustee and the rate specified in the contract for such performance."

Mr. Gerdes says:

"If a receiver or a trustee rejects a lease in an equity receivership or bankruptcy proceeding, the lessor has a claim against the estate in administration to the extent of the reasonable value of the premises for the time during which the trustee or receiver used or occupied them, or, if the premises were subleased by the debtor, a claim for or lien upon the net rents collected by the trustee or receiver up to an amount equal to the rental stipulated in the lease."

It is also an important consideration in this case that the provision for rejection is contained in the plan. The Trustees, pursuant to court order (R. 75) entered August 27, 1935, have paid the interest upon the Terre Haute Bonds, together with taxes and the stipulated sum for corporate expenses required to be paid under the Terre Haute Lease. The Trustees have neither expressly adopted nor rejected the lease and the provision inserted in the plan, pursuant to the express terms of Section 77 (b), is the first definite action upon the subject that has been taken. The time within which the Trustees may express their election has been extended from time to time by Court orders and has not expired. Obviously, if the Trustees had expressly adopted the Terre Haute Lease and paid the rental stipulated, their obligation to the date covered by such payments would be discharged, and the statute expressly provides, Section 77 (b), that the prior adoption by a trustee shall not preclude rejection in a plan or change the character of the claim resulting from such rejection.

We submit that the real question involved in all such cases is what, under all of the attending circumstances, is reasonable compensation to be allowed for the use of the property by the trustee. Certainly, it cannot exceed the amount stipulated in the lease.

The lessor's right to damages for rejection is not affected by the provision fixing the effective date for rejection in this proceeding. The measure of damages is generally stated to be the rent prescribed by the lease less the rental value. In case of long term leases, the problem of certainty as to damage is involved and in a recent case this Court limited the period for computing the rentals in the case of a 999-year lease to eleven years which represented the maximum period as to which the evidence was sufficiently certain.

Palmer v. *Connecticut Ry. Co.*, 311 U. S. 544.

If the rental value exceeds the stipulated rental, obviously there is no damage. Under the provision of the plan in this case, if the Terre Haute Lease is rejected, the Terre Haute will receive the stipulated rental to the effective date of rejection prescribed by the plan. It necessarily follows, therefore, that in computing the damage resulting from breach, none could be allowed for the period from bankruptcy to the effective date of rejection. In any event, if there is rejection, the lessor will have a claim for such damages as accrue which claim will be a general claim. As stated in the Commission's report:

> "In the event the proposals be rejected, and the alternate provisions of the plan with respect to the Terre Haute become operative, all claims for damages growing out of the unfulfilled provisions of the rejected lease and the guaranty of the income bonds, in order to be recoverable at all against the debtor's estate, as we understand the matter, would have to be filed with the court in this proceeding. It is also our understanding that such claims would have the status of general unsecured claims. Accordingly, the holders of such claims, to the extent allowed by the court, would participate with other general unsecured

creditors in the distribution of such new securities as are provided and available under the plan." (R. 1304.)

The Terre Haute Group seem to be under the impression that, in case of rejection, they are entitled, as a matter of right, to the earnings of the property from the date of bankruptcy forward, and, in addition, to a substantial claim for damages for breach of the obligations of the lease, as of that date. In other words, they claim that they would be entitled to more in such case than they would under the statute had the Trustees specifically adopted the lease and then the plan should have directed its rejection. That situation is covered by the provision of Section 77 (b) to the effect that:

> "The adoption of an executory contract or unexpired lease by the trustee or trustees of a debtor shall not preclude a rejection of such contract or lease in a plan of reorganization approved hereunder, and any claim resulting from such rejection shall not have priority over any other claims against the debtor because such contract or lease had been previously adopted."

There are these further considerations. The Milwaukee owns 97% of the Terre Haute stock and would be entitled to that portion of any net earnings. The interest of the Terre Haute is entirely a bondholder interest and bondholders have received their interest to date pursuant to Court order. Clearly, it would have been inappropriate for the plan to make any provision which would have permitted the bondholders to retain their interest and would, in addition, have permitted the Terre Haute to receive and retain the net earnings.

The provision of the plan fixing the effective date of rejection is clearly authorized by the statute. Section 77 (b) provides not only that a plan may reject unexpired leases and may include any other appropriate provisions not inconsistent with the section, but also provides that the plan shall include provisions modifying or altering the rights of creditors generally or of any class of them,

secured or unsecured. Upon rejection of the Terre Haute Lease, the Terre Haute Bondholders will have a claim for damages and will become creditors with whose rights the plan may appropriately deal and under the authority of the statute there would seem to be no question of the right of the plan to fix a date when such rejection will become effective and to determine the rights of the parties with reference to that date. The District Court fully approved the action of the Commission upon this question. (R. 1881-1883.) The Circuit Court of Appeals in no way criticizes this provision of the plan. We submit that the plan provides a correct determination of the Terre Haute issue and that a correct determination of that issue is essential to enable the Milwaukee to be reorganized on a sound basis.

Conclusion.

The Trustees have discussed those questions which they feel it is appropriate that they should discuss in this proceeding and they submit that the provisions of the plan with reference to the Additions and Betterments Fund and also with reference to the treatment of the Terre Haute Lease are sound, are in accordance with the provisions of the governing statute, are fully supported by the record, and particularly by the report of the Commission and the reasons therein contained, and that no other or additional findings are required to justify their approval.

Respectfully submitted,

A. N. Whitlock,

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Dated September 23, 1942.